[redacted]

Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

23 June 1983

Hong Kong: Deteriorating Economic Conditions [redacted]

The economic climate in Hong Kong has deteriorated sharply during the past two months. Investor confidence has waned as political uncertainty has mounted over the form of a Chinese takeover in 1997 and is the major factor in the slide. The Hong Kong dollar broke the psychological barrier of $7 HK/$1 US in May and continued to weaken despite government open-market intervention and a two percentage point increase in interest rates. The Hong Kong stock index, which had been on upward trend since last December, turned sharply downward in May. Efforts to rescue several failing financial companies and three large property concerns are also meeting little success. [redacted]

Short term prospects for an economic rebound are nevertheless good. Speculative pressure against the currency has shown signs of easing somewhat and Hong Kong exports have begun to respond to Western economic growth. Inflation, however, will remain a major problem owing largely to the currency depreciation. [redacted]

Over the next five to seven years, the continued political uncertainty surrounding 1997 will retard positive economic growth and deepen economic downturns. Unless London and Beijing can reach some agreement for takeover that reassures investors, we expect cyclical fluctuations to become more severe. The currency will probably continue to weaken over time and the Hong Kong stock market will reflect increasing investor uncertainty. [redacted]

Economic Upturn and Investor Uncertainty

Hong Kong began 1983 with most major economic indicators improving. Exports--the engine of growth in the colony--were up an estimated 5 percent in real terms during the first four months after a 2 percent decline in 1982. Bankruptcies, mostly tied to

[redacted]

This memorandum was prepared by [redacted] *the Office of East Asian Analysis. Questions and comments are welcome and may be directed to the author* [redacted]

[redacted]

[redacted]

the major slump in the property market during 1982, were easing somewhat as residential buyers returned to the market. Reflecting the overall improvement, the Hang Seng index of stock climbed 235 points--30 percent--from 1 January to 30 April of this year. [redacted]

Despite these positive indications of economic recovery, the local currency has been gradually losing its foreign purchasing power since January this year. The strengthening US dollar probably explains much of the early decline; most other Asian currencies were also losing ground during this period. But waning investor confidence took over in May cutting more than 5 percent off the currency's value against the 15 major currencies and nearly 10 percent off its value against the dollar in a one month period. By 10 June, a nadir of $7.5 HK per US dollar was struck, and since then the currency has strengthened only slightly. [redacted]

China plans to take control of Hong Kong in 1997 and local investors are jittery about economic prospects under a communist regime. Although Beijing has gone to great lengths to publicize its intention to leave the colony's social and economic status quo unchanged after takeover, local businessmen remain unconvinced. Moreover, talks between London and Beijing, that most Hong Kong residents hoped would bring some form of continued British presence in the colony after takeover, have not gone well. After making virtually no progress for the past eight months, the talks are only now apparently getting underway again. [redacted]

No figures for capital flight are available. Bankers in Singapore, Thailand, Sri Lanka, the United States, and Canada reported increasing injections of Hong Kong capital late last year when a similar bout of nervousness sent the Hong Kong dollar into a less severe tailspin. These same countries were probably major recipients during the most recent scare. In addition, local savers are shifting out of Hong Kong dollar deposits in favor of foreign currencies and gold. We estimate that about 60 percent of Hong Kong bank deposits are now being held in foreign currencies compared with 38 percent a year earlier. Although figures for 1983 gold imports are unavailable, purchases from Western Europe reportedly jumped 50 percent in 1982 to more than 135 tons. With the exception of Singapore, other Far Eastern countries reportedly experienced declining gold imports during the same period. [redacted]

Government Attempts to Restore Stability

Thus far the Hong Kong Government's efforts to stem the flow of currency and to bolster sagging confidence have met with little success. The government probably attempted to support the currency with small-scale open market purchases of Hong Kong dollars in mid-May and early June; with only an estimated $3-4 billion in its foreign currency reserve fund, long-term, large-

[redacted]

0 8 2 8

scale intervention is impossible. By mid-month the government resorted to a more drastic measure to halt the outflow, pressuring the Hong Kong Association of Banks (HKAB) to raise interest rates two percentage points. HKAB's announcement of the upcoming rate increase bolstered the currency for two days. By the time the increase actually went into effect, however, the dollar was once again sinking to new lows. [redacted]

Nor was its failure to halt the downward slide of the currency the only negative aspect of the rate increase. Hong Kong's always volatile stock market plunged as a result of investor fears that the rate increase would stymie economic recovery. The market lost 40 points (5 percent) on 23 May, the day the increase went into effect. Two of Hong Kong's largest textile manufacturers are among the many industrial firms currently attempting to stave off bankrupcy with short term borrowing. Major property companies--among the biggest investors in the Hong Kong stock market--are also in need of significant amounts of short-term funds. [redacted]

Outside Support

The largest foreign holder of Hong Kong currency is probably China's official foreign exchange bank--the Bank of China. Although no figures are available on total Bank holdings, Beijing's exports to Hong Kong in 1982 alone amounted to $ 5.4 billion, almost entirely paid for in Hong Kong dollars. [redacted]

Hong Kong could probably also turn to the Bank of England for support. Although such a move would be unprecedented, we believe that the Bank would be willing to work out some type of swap* arrangement if the economic deterioration was deemed extreme. Bank of England support would probably give investor confidence a major boost and, at least temporarily, could discourage speculative pressure on the currency. [redacted]

* Under a swap agreement, the Bank of England would make pounds Sterling available to the Hong Kong Government in exchange for an equivalent amount of Hong Kong dollars at an agreed rate. The pounds Sterling could then be used in open market operations.

Prospects

In the short run, we believe Hong Kong's prospects for economic recovery are good. During the past few days the currency has shown signs of leveling-off at about $7.0 HK/$ 1 US. Stronger than expected recovery in the West bodes well for sharp increases in exports this year. Major gains in the export sector would help bolster confidence colony-wide and could contribute to overall economic stability during the remainder of the year. With the 1997 deadline still 14 years away, investors probably continue to see sizable short-term opportunities in the Hong Kong market. Although the recent hike in interest rates will hinder growth somewhat, we expect to see GDP rise 5 percent by yearend on the strength of exports. Unemployment should fall below its current peak of 5.1 percent to perhaps as low as 3-4 percent. [redacted]

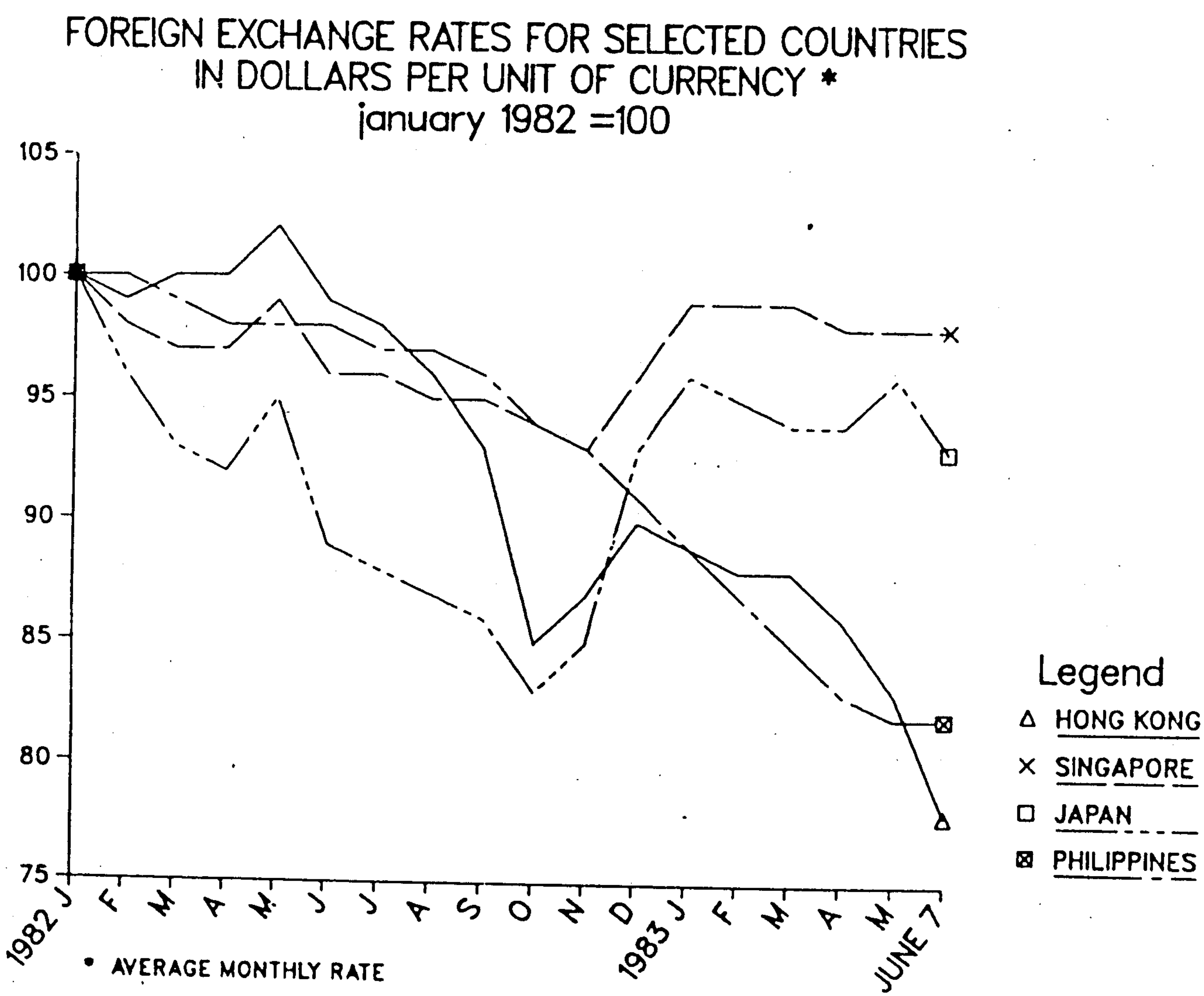
Because the colony is totally dependent on imports for food, energy, and industrial raw materials, we expect the recent depreciation will hamper efforts to arrest inflation. Gasoline prices jumped nearly 2 percent in May alone, and other increases are imminent. By yearend the consumer price index will probably be at least 15 percent above last year's level. In fact, the price increase will probably offset any beneficial effect of the depreciation on Hong Kong exports. Although the currency should regain some of the ground lost recently we do not expect it to approach the 1982 average rate of $6 HK. [redacted]

As long as residents remain uncertain about the Colony's future, long-term economic prospects for Hong Kong remain gloomy. A large number of the Colony's residents are making efforts to get at least one member of their immediate family established overseas; Hong Kong's most highly trained workers are likely to be among the most successful in leaving the colony. Moreover, investors, even those publicly praising the current Chinese leadership and its policies, are diversifying their investments and moving capital offshore. [redacted]

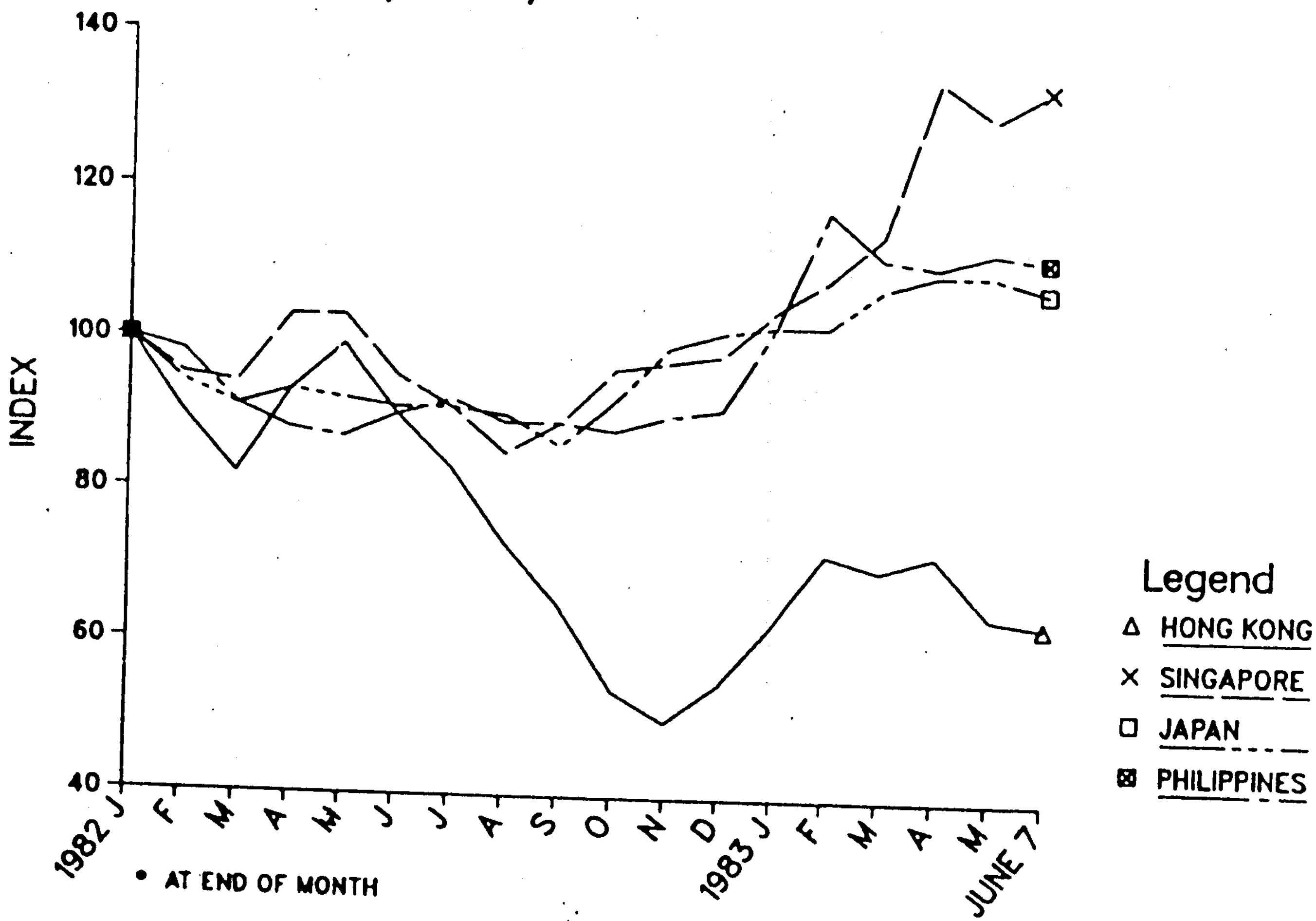
The drain on investment funds and skilled workers will constrain Hong Kong's long-term growth. Although we expect a generally upward trend over the next 5 years, Hong Kong's growth rate will fall far short of historic levels and probably remain well below rates being achieved by its traditional competitors in the area. Nor will the increase be smooth. Cycles--spurred by investor uncertainty and fueled by speculation--will probably be more frequent and of increasing magnitudes. Potential for economic collapse will be at its peak during these cycles. [redacted]

We believe that, in the long run, the floundering economy will pressure Beijing to exhibit flexibility in its negotiations with the British. At present, however, Beijing appears convinced that it can pacify Hong Kong investors and maintain economic vitality without a significant British presence and, hence, will probably continue to take a hardline approach. Beijing's

recognition that this approach is causing severe problems and modifications in Chinese demands might not, however, come until investor confidence in Hong Kong has been irreparably damaged. [redacted]


FOREIGN EXCHANGE RATES FOR SELECTED COUNTRIES
IN DOLLARS PER UNIT OF CURRENCY *
january 1982 =100
105
100
95
90
85
80
75
1982 J
F
M
A
M
J
J
A
S
O
N
D
1983 J
F
M
A
M
JUNE 7
* AVERAGE MONTHLY RATE
Legend
HONG KONG
SINGAPORE
JAPAN
PHILIPPINES

STOCK INDEXES FOR SELECTED COUNTRIES*
january 1982 = 100



* AT END OF MONTH

HONG KONG: VOLUME OF TRADE